Is the European common currency worth it?

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Previous Article 5 of 13 Next
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Abstract:
Ten Euromyths about the potential benefits of a common currency for Europe are: 1. The world is moving from flexible to fixed exchange rates. 2. Speculators and derivatives have made flexible exchange rates more volatile. 3. Flexible exchange rates inhibit international trade. 4. Europe is a natural common-currency area. 5. The euro will mean lower inflation. 6. The euro will mean lower unemployment. 7. The euro will mean moderate business cycles. 8. The euro will moderate regional and national disparities. 9. Within the EMU, fiscal policies will compensate for monetary policies. 10. The euro will eliminate balance-of-payments problems.

Full Text:

Is the Economic Monetary Union here at last? Brussels' Eurocrats have propogated ten "Euromyths" about the potential benefits of a common currency for Europe. The author says that none of these survives close scrutiny.

An old joke describes an economist stranded on a desert island with an engineer and a chemist and nothing but a can of beans between them. The engineer suggests opening the can using ingenious mechanical devices. The chemist sets to work formulating ways of concocting acids from the plant life available on the island. The economist is somewhat more conjectural. "Let us begin," he asserts, "by assuming a can opener."

By this standard, the economic bureaucrats in Brussels are true to their training. They are determined to introduce a single currency across fifteen countries that speak eleven major languages, with sharply different political and legal institutions, with highly disparate stocks of public debt and with dramatically different levels and rates of growth of productivity. As well-trained economists, they seem to be saying, "Let us begin by assuming that in 1999, none of this will be true."

Of course, it will be true in 1999. The smart money at the moment is betting that, at most, eleven of the fifteen hopeful European Union (EU) debutantes will actually make it to the Euro Ball. And what will happen to the remaining wallflowers who have to stay home? Rumor has it that they might not be as popular as before in Brussels and Bonn, and that they might even be accused of "competitive devaluation" or "unfair competition" if their currencies happen to fall against the new euro.

Well, we in North America are just waiting to scoop up the broken hearts and make good the broken dreams. We believe that although those who do not join the Economic and Monetary Union (EMU) may become second-class citizens of Europe, they will remain first-class citizens of the world. We in North America would rather buy Italian shoes as valued by a depreciated lira than French shoes with the franc fort, and if the pound sterling remains realistically priced, we would rather buy a Jaguar than a Mercedes. We might also be more inclined to invest in Spain or Portugal than in Austria or Belgium. In an effort to lure debutantes to the magnificent Euro Ball of 1999, the evil Eurocrats in Brussels have promulgated a long list of luring attractions. Unfortunately, not one of these attractions is nearly as attractive as the Eurocrats would have us believe. I would not want to call them lies, but I will go so far as to call them myths. The first of these myths is: "Everybody's doing it, so why not you?" Euromyth Number 1: The World Is Moving from Flexible to Fixed Exchange Rates Ten years ago only eight of the world's major countries had fully flexible exchange-rate regimes. Fourteen countries employed managed regimes, and sixty-four maintained fixed exchange rates. Today some thirty-three countries operate under flexible regimes, eighteen under managed, and only forty under fixed. There are several ways of interpreting these facts. Advocates of fixed rates might argue that the apparent unsustainability of fixed regimes reflects a lack of monetary discipline and that rigidly fixed rates, bound by a currency board or, better still, a common currency, would automatically enforce monetary discipline.

However, the past fifteen years have seen convergence of national inflation rates rather than the reverse. In the developed world, inflation rates have fallen from double- to single-digit levels and in the less-developed world from triple- to doubledigit levels or below. The highest inflation rate in the EU is Italy's, at 5.3 percent. Inflation in the other fourteen members of the EU is even lower. This is hardly a set of countries in need of stern monetary discipline, at least at the moment.

On the contrary, rates of productivity growth have not converged. Nor is the world any freer from oil shocks, earthquakes, or beef scares than it was fifteen years ago. To retain its export competitiveness in the face of relatively low productivity growth or unpleasant shocks, a country must perforce devalue or depreciate its real exchange rate. If the unfortunate country is locked into a fixed nominal exchange rate, it must deflate internally, by lowering its wages, prices, and incomes relative to its competitors. In practice, this means an unpalatable period of recession and unemployment. Exchange-rate depreciation permits adjustment to the new reality with much less pain.

Hence, countries from Britain to Mexico have fallen off the fixed-exchange-rate wagon, not necessarily because their inflation rates were irresponsible, but because, for various reasons, their real exchange rates no longer reflected economic reality. Had they been using flexible rates all along, the sudden, sharp devaluations, with their attendant losses to taxpayers and windfall gains to speculators, would not have been necessary "Ah," the Eurocrat says, "But if you allow yourself to fall for a flexible rate, you will be preyed upon by rapacious speculators who will drug and deceive you with horrible nasty devices picked up off the streets of New York. They're called 'derivatives,' darlings, and don't you ever, ever use one. In fact, if you stay at home here with us in Brussels, you'll never, ever have need of one." Euromyth Number 2:

Speculators and Derivatives Have Made Flexible Exchange Rates More Volatile It is true that exchange rates are now more volatile than they were in the 1960s, when capital markets were tightly controlled and all major exchange rates were fixed. After the collapse of the Bretton Woods arrangements in 1973, speculators entered the scene in force. They make money by buying low and selling high, and as long as they do that, they should smooth out market fluctuations, not exaggerate them. Since the 1970s, the honest work of speculators has become ever more efficient, as derivatives such as exchange-traded futures and options have become available. Simply put, derivatives allow speculators to bet on larger amounts of foreign exchange for a given outlay of cash and therefore should enable them to smooth the market more effectively

Understandably, Eurocrats and many other observers of recent derivative disasters are suspicious of this kind of armchair reasoning. However, the numbers support the theory. The standard deviation of monthly percentage changes is a simple measure of short-term volatility. By this measure, exchange-rate volatility rose from 0.4 in the 1960s to 1.3 in the 1970s, 1.7 in the 1980s, and then down a sliver to 1.6 in the 1990s. This is hardly evidence of an explosion of chaos over the past twenty years, when derivatives have come into their own. Nevertheless, Eurocrats complain that flexible rates are much too complicated for smaller countries to deal with on their own. "You will never be able to sell your wares abroad because you'll never know what price to charge," claims the Eurocrat. Euromyth Number 3:

Flexible Exchange Rates Inhibit International Trade Dozens of econometric studies have tried to establish a link between the volatility of exchange rates in Western Europe and the volume of international trade. None has established any link. Foreign exchange hedging, using forward trading, futures, and the like, can remove short- and medium-term exchange rate risk at very little cost. Canada has perhaps the longest experience with floating exchange rates since World War II. Yet its external trade-over 80 percent of which is with the United States-has been unimpeded. And during the 1980s, when the U.S. dollar was extremely unstable against the yen and the Deutschmark, both American and Japanese trade volumes grew at unprecedented rates.

It is of course true that converting between currencies entails transaction costs. These conversion costs now absorb about 0.4 percent of Western Europe's gross domestic product (GDP) each year. This is not a trivial cost, but it must nevertheless be weighed against the likely costs of a common currency, which would be much higher. Transaction costs are essentially the same whether exchange rates are fixed or flexible. The additional hedging cost associated with flexible rates is the extra transaction cost of converting a currency forward rather than spot, and for the major currencies that extra cost is very small. The only way of avoiding conversion costs, per se, which are substantially higher than hedging costs, is to move from fixed exchange rates to a common currency.

The only unambiguous benefit associated with a common currency would be saving the transaction costs attached to converting between currencies-estimated at 0.4 percent of GDP annually, although this is likely to fall as electronic technology becomes more sophisticated. The costs of a common currency are likely to be much higher than 0.4 percent of GDP

Admittedly, much of this argument against the common currency rests on an assessment of the relative advantages of flexible rates. However, even fixed rates, especially if they are fixed within a band as they are in what remains of the European Monetary System (EMS), are likely to be superior to a common currency At least the countries in the EMS joined voluntarily, maintain some control over their own economies, and can leave if circumstances change. Joining a common currency is more like an arranged marriage-in fact, an arranged group marriagefrom which divorce is impossible even under circumstances of extreme abuse.

The Eurocrats in Brussels are arranging the debutante ball because they hope it will lead to a marriage. In many cultures, arranged marriages work well because the parents who arrange them are careful to confine their matchmaking to girls and boys from the same class and caste and, usually, the same corner of the country. But the girls and boys at the Euro Ball not only come from different countries, but do not even speak the same language. They are propagating Euromyth number 4.

Euromyth Number 4:

Europe Is a Natural Common-Currency Area Certainly few people in the United States need to be persuaded of the economic and cultural differences within Europe. According to the latest World Competitiveness report released by the Institute of Management Development in Lausanne, only three countries in the EU are among the world's top ten economic "competitors," with Italy and Portugal placing thirtieth and thirty-first, respectively. Measures such as these underscore vast differences in productivity even between countries within Western Europe. And the future will probably bring major differences in productivity growth-for example, productivity in Italy and Portugal will probably continue to grow faster than in Germany and France.

Thirty years ago a distinguished Canadian economist, Robert Mundell, laid out two conditions for an optimal common-currency area. The first is that the regions within the area should be subject to common real economic changes with common effects. The second, which to some extent can make up for the absence of common economic change, is that labor should be mobile between regions so that workers can migrate if one region flounders while another prospers.

Within Europe, sharp differences in productivity suggest that economic change is likely to be divergent. It is true that integrated economies are more likely to experience symmetrical economic change: Both Belgium and Luxembourg score high on integration, with intra-EU trade accounting for more than 40 percent of their GDP But the five largest EU economies-Britain, France, Germany, Italy, and Spain-are not well integrated, trading only 10-12 percent of their GDP within the EU. Compare this with Canada, which trades 22 percent of its GDP with the United States, yet has no interest in monetary union. Moreover, sharp cultural differences within Europe suggest that labor mobility is likely to remain limited. Labor is almost three times more mobile between U.S. states than it is between individual EU countries. It is hard to pretend that Europe is an optimal currency area.

If agricultural productivity grows faster in Poland than in France over the next ten years, which is likely, and if Poland joins the EU and is allowed free access to French markets, Poland will run a large agricultural trade surplus with France. Under present arrangements the Polish zloty is likely to appreciate in value, moderating the trade surplus. Under separate currencies and flexible exchange rates this would occur quite naturally, but under a common currency it would occur only as a result of higher wage and price inflation in Poland or lower wage and price inflation in France. This could be extremely painful for both countries because in the real world, prices and wages are rarely flexible enough to react to economic change without causing unemployment. In short, if Poland were to join the common currency in 1999 (an extremely unlikely prospect), the result would probably be more unemployment and unrest among French farmers than at present. And of course it would be extremely unlikely that French farmers would choose to move to Poland. "Ah, yes," say the Eurocrats, "We grant you that wages will have to rise faster in some countries than in others, but the overriding goal is to keep overall wage growth in line with overall productivity growth. The only way to guarantee this is to have one currency and one central bank for all. Short of that, Europe will not be able to control inflation." Euromyth Number 5:

The Euro Will Mean Lower Inflation Conventional wisdom has it that fixed exchange rates lead to lower inflation-or, more precisely, are a sufficient condition for lower inflation. Fixed exchange rates are certainly not necessary to achieve lower inflation. For example, Canada-with the help of a single-minded (some would say bloody-minded) central banker (imported from Britain by way of the International Monetary Fund)-brought its inflation rate down to the lowest in the world (almost zero percent) without pegging its exchange rate to the U.S. dollar, the Argentinian peso, or anything else. Fixed rates are not sufficient for monetary discipline either: Mexico, for example, persisted with easy money despite its peg to the U.S. dollar, although it ultimately paid the price. But conventional wisdom is more or less correct if it applies to countries with politically susceptible central banks that are firmly committed to maintaining their exchange rates fixed to a country with a politically independent central bank. The EMS has probably disciplined member countries and lowered inflation rates, but only because the German Bundesbank was already disciplined. Of course, several countries within the EMS maintained inflation rates higher than Germany's because they were able to exercise the ultimate option of pulling out of the regime.

Conventional wisdom has it that moving beyond fixed rates to a common currency will remove the option of pulling out and will therefore enforce sustained discipline on weak-willed governments such as many of the governments of Italy, Spain, and Great Britain. But this argument conveniently ignores the reality that the new European central bank will reflect the political and economic preferences of all member countries, not just Germany In fact, underlying France's enthusiasm for the euro is a thinly disguised desire to dilute Germany's hegemonic control over European monetary policy. The political reality is that once Latin (and Anglo-Saxon!) votes are included, European monetary policy under the euro will probably prove more inflationary than it has been under the EMS. This is especially likely given Europe's chronically high unemployment. Euromyth Number 6:

The Euro Will Mean Lower Unemployment A key word to describe European unemployment is "chronic"; a more evocative term for Europe's general blight is "Eurosclerosis." Structural unemployment-the mismatch of job qualifications with job opportunities that is a necessary by-product of technical progress everywhere in today's world-lasts longer in Europe because wages are more rigid and labor mobility is lower. Labor mobility in Europe has always been lower than in North America for reasons of language and culture. Thirty or forty years ago, before Europe caught this disease, unemployment rates were lower in Europe than across the Atlantic. Now, after two decades of deregulation in North America that has not been matched in Europe, the reverse is true. Structural unemployment cannot be reduced with expansionary monetary or fiscal policies, and this is why economists, somewhat misleadingly, now call it "natural" unemployment. Nevertheless, countries with high natural unemployment rates are likely to push for easier monetary policy than is consistent with low inflation. Except during brief periods, easier monetary policy will not buy lower unemployment: It will merely mean periods of high inflation followed by painful periods of recession once the inflation becomes unacceptable.

In other words, both the ups and the downs of the business cycles are likely to be exacerbated relative to the present system, in which where monetary policy, at least for the remaining members of the EMS, emanates from Bonn. Euromyth Number 7:

The Euro Will Moderate Business Cycles The logic articulated above suggests that the present EMS, with exchange rates fixed to a non-inflationary German mark, does a decent job of moderating the extremes of business cycles, given this imperfect world. More precisely, the logic suggests that, given a choice between the present system where Germany dictates monetary policy for all of Europe and the plans for 1999 in which monetary policy is to be run by implicit consensus, the present system is likely to be both less inflationary and more stable. But, given a choice between either the present or planned systems and a system with flexible rates, the prognosis is not so clear. Since Europe satisfies neither of the conditions for optimal currency areas, when a European country experiences a shock whose impact is not common to all of Europe, the ideal response is compensating monetary policy for that particular country, but not for all of Europe. Thus lower oil prices might call for expansionary monetary policy in Norway but certainly not throughout Europe. Under either fixed rates or a common currency, Norway would be denied the luxury of monetary policy independent of Europe's and would thus be forced to bear the brunt of the oil shock. Without high labor mobility, unemployed Norwegians would be trapped in Norway.

The general point is that flexible exchange rates preserve the option of independent monetary policy and therefore the option to counter undesirable demand shocks to a country's economy Of course the potential benefits of preserving this option must be weighed against the risks that politically pressured central banks might misuse it or simply misjudge the need to use it. The issue is whether modern central banks are endowed with sufficient integrity and skill to be trusted with the conduct of monetary policy.

That issue is, of course, debatable. Personally, I am enough of a Keynesian to believe in the desirability of active monetary policy After flirting with rule-dominated monetarism in the late 1970s, virtually all the world's central banks gave it up. Certainly Alan Greenspan, chairman of the United States Federal Reserve Board, has managed to conduct non-inflationary monetary policy while remaining highly proactive in an successful effort to moderate U.S. business cycles.

Among academic economists, prevailing sentiment has moved in the 1990s toward New Keynesianism, which recognizes that, in the real world, wage adjustment and labor mobility take place too slowly to leave the business of moderating business cycles entirely to the free market. More precisely, since some markets (e.g., money and foreign exchange markets) adjust much faster than others (e.g., labor markets), it would seem foolish to relinquish national control over the former.

Just as the common currency is unlikely to moderate instability over time, it is also unlikely to moderate instability over space. Yet that is exactly the myth the Eurocrats seem to be selling us when they suggest that in our new group marriage we will share not only the same bed but the same quality of pajamas. Euromyth Number 8: The Euro Will Moderate Regional and National Disparities The euro is unlikely to moderate regional disparities, and it is even less likely to even out national disparities. When coal mines close in Wales, there is considerable opportunity for coal miners or their families to move to Manchester but much less opportunity for them to move to Metz or Madrid. As long as Britain retains the option to lower interest rates or allow the pound sterling to depreciate, it retains the option to stimulate demand and encourage migration from regions of high unemployment to regions of low unemployment. Of course, this option should not be exercised if it is likely to prove inflationary, and in any case it will not be sufficient to eliminate unemployment in Wales overnight. Much of the adjustment will depend on keeping wage rates low in Wales relative to Manchester. Nevertheless, it is fairly certain that Britain will be able to manage regional unemployment better if it retains control over its monetary and exchangerate policies than if it delegates them to Brussels.

What is absolutely certain is that Britain will be able to manage its national unemployment better if it is able to manage its money, and by extension its exchange rate, independently of Brussels. In other words, if by regional disparities we mean national disparities, the Euro-speak suggesting that these will lessen under a common currency is very clearly a myth. On the contrary, the euro will lock Europe into common aggregate demand policy that cannot help but be a compromise for most member countries most of the time.

A related myth is that Brussels will compensate for the loss of independent monetary policies by means of compensatory fiscal policy

Euromyth Number 9:

Within the EMU, Fiscal Policies Will Compensate for Monetary Policies Despite two "common currencies," the vast regional disparities in Canada and the United States are no worse than they are because of automatic compensatory fiscal policy Thus, when incomes are relatively low in the state of Arkansas or the province of New Brunswick, tax payments to Washington and Ottawa are disproportionately lower and transfer payments are disproportionately higher. Canada has carried regional redistribution one step further, with massive net transfers from rich provinces to poor provinces, administered by Ottawa using federal tax revenues.

European countries pay taxes to their national capitals, not to Brussels. If one member of the EU or the EMU falls into dire straits, there is no automatic mechanism whereby transfer payments relative to tax collections can increase except by running a fiscal deficit. The conditions for joining EMU as decided at the Maastricht conference place strict limits on that option. In practice EMU members will have to rely on Brussels for explicit redistribution, Canadian-style. In Canada, this type of redistribution policy is unpopular and divisive. Most, if not all, of the ten provinces are not happy with the large amount of power they surrender to Ottawa. It is hard to believe that Britain or Italy is going to be any happier surrendering fiscal control to Brussels.

Perhaps the best way to summarize the case against the common currency is to articulate a tenth and final myth. Although perhaps no respectable Eurocrat has ever uttered this particular myth (Eurocrats are far too highly educated for this one), it nevertheless persists just beneath the surface in the popular press and in the popular mind. Euromyth Number 10: The Euro Will Eliminate Balance-of-Payments Problems This is really a mega-myth. When imports and exports between two countries with separate currencies are of unequal value, one country has what we call a balance-of-trade surplus and the other has a balance-of-trade deficit. The surplus country then exports capital to deficit countries, and it may accumulate foreign exchange reserves as well. The mega-myth is that these trade and capital deficits and surpluses cannot occur under a common currency The only difference between the separate- and common-currency cases is semantic. Within common-currency areas the words "balance-of-payments problems" are not used as often. But almost inevitably any common-currency area experiences just such problems.

Consider Canada. In many ways Canada is not an optimal common-currency area: The bulk of the population and economy is stretched, despite geographic imperatives, along a 4,000-mile border with the United States. As a result Canada has terribly troublesome regional inequities, which reflect, in turn, regional balance-of-payments problems. Some regions are net exporters of goods and services; some are net importers. Canada's common currency masks this fact since regional trade balances are not well publicized the way international trade balances are.

The consequence of Canada's regional trade imbalances is the relentless downward pressure on wages in the net importing regions-the Maritime provinces in particular-in order to make their exports-such as McCain's frozen foods-more competitively priced. But the downward pressure on wages is never sufficient to generate full employment in the Maritimes. The combination of low wages and unemployment does encourage migration to more prosperous parts of Canada, such as Ontario and British Columbia, but for 100 years there has never been enough migration out of the Maritimes to solve their problem. Canada's regional disparities would be reduced if the Maritimes could float an independent currency-the currency of deprivation (COD). The COD would rapidly fall to a sufficient discount against the Canadian dollar to balance the Maritimes' trade deficit with the rest of Canada, and unemployment in the Maritimes would decline. Currency prices fall much more rapidly than do wages and with much less painful side effects. On economic grounds, it is arguable that Canada should split into currency regions. On political grounds, the last thing Ottawa wishes to do is encourage regional separatism at this delicate point in Canada's history Any economic argument against separate currencies must rest on precedent and reputation: The Canadian dollar has a reputation for integrity because of a history of responsible monetary management. The COD would not: Currency markets would likely be suspicious that the COD would be subject to intense political pressure. The markets would fear that the central bank in Halifax might be subscribing to something closer to a fish standard than a gold standard, in a misguided attempt to generate prosperity through inflation and devaluation.

Most West European currencies also have a reputation for integrity and a tradition of acceptability, partly because responsible monetary management has been enhanced by the past fifteen years of German hegemony. To replace tried and true existing currencies by an untried and untested euro requires a leap of faith toward monetary management from Brussels that the currency markets may not be willing to make. It is hard to believe that the euro will be more desirable as a hedge against inflation than the core currencies it is intended to replace: the German mark, Benelux currencies, Austrian schilling, Finnish markka, French franc, or even the Irish punt.

Consider the following item from the Wall Street Journal on January 30, 1996: "Traders bought. . German currency out of fear that the timetable for the single European currency is unrealistic. Investors turned to the mark on the assumption that it would be a more attractive investment by itself than melded into a basket of European currencies that don't have its postwar record of stability."

If the euro does come along, however, there will be no more Deutschmark to invest in. Economist Avinash Persaud at J.P Morgan in London stated: "German money is flowing into Switzerland for safety.... People in Europe think European economic and monetary union is for real; they fear the Bundesbank won't be around in five years.... Switzerland is going to be the new Japan of Europe, as investors increasingly look upon the Swiss National Bank as a substitute for the Bundesbank" (Wall Street Journal [September 22, 1995]). Or consider this somewhat more romantic item, published in the Wall Street Journal on Valentine's Day, 1996: "Sterling gained steadily against the dollar and the mark.... Encouraging sterling buyers is the perception that it is unlikely European economic and monetary union . . . will occur by January 1, 1999. Sterling, which isn't expected to participate, is acquiring a 'safehaven' image because of doubts about EMU."

Admittedly, comments such as these are mostly rationalizations after the fact of whatever direction the Deutsche mark or Swiss franc or pound sterling happens to be taking. Nevertheless, it is by no means certain that the currency markets will embrace the euro with open arms if and when it appears. In the opinion of Graham Broyd, senior vice president at Natwest Markets in New York, "Instead of buying marks as a safe currency in times of EMU uncertainty, . . investors may flee Europe altogether" (Wall Street Journal [January 1, 1996]). This is a far cry from the Brussels party line, which has the euro emerging to rank with the dollar as one of the world's mightiest moneys.

Even if EMU does occur (which it will) and even if the euro does preserve responsible monetary management (which it might), the hard fact remains that it will impose common monetary (and exchange-rate) policies on a collection of countries that do not comprise an optimal common-currency area. It is hard to believe that this collection of countries will never be hit by differential shocks. They will certainly experience differential productivity growth. In the absence of compensatory monetary and exchange-rate policies, these differential real economic changes will place an extraordinary burden on internal wage and price adjustment, as well as on the migration of labor. My guess, therefore, is that the euro will increase rather than decrease balance-of-payments problems, which will be symptomatic of much more than accounting problems in the lives of ordinary Europeans.

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